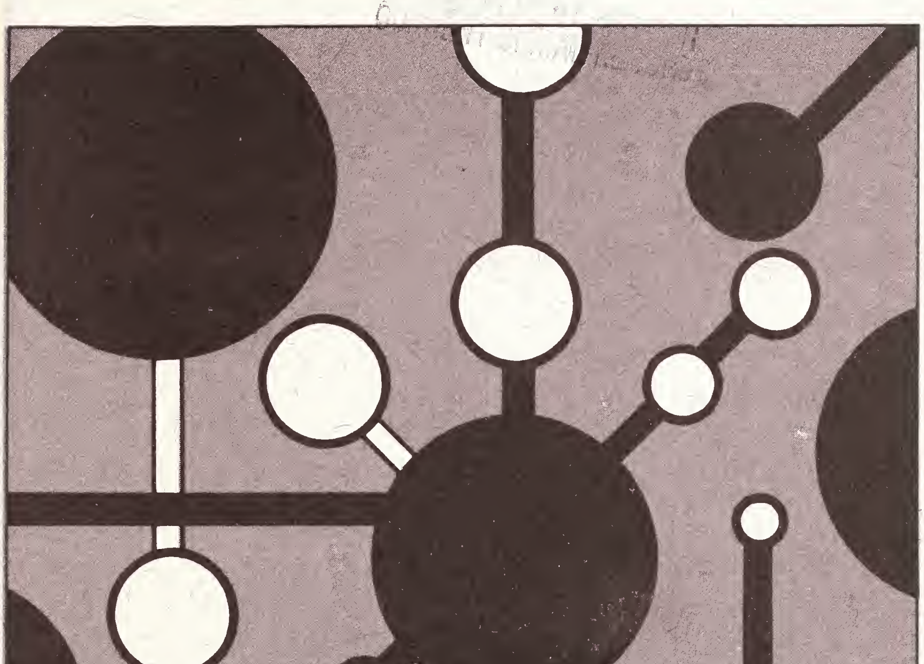
Subsidiaries Of Agricultural Cooperatives



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Cooperative Research Report 4

Preface

Little is known about why or to what extent cooperatives use subsidiaries for carrying out various functions. Their increasing use, indeed, the increasing dependence of some regional cooperatives on subsidiaries, has implications for other cooperatives considering this organizational tool.

This study was undertaken to answer some of the questions concerning the use of subsidiaries.

1. Why were the subsidiaries established?

2. What are the important advantages and disadvantages of using a subsidiary compared with a division or department within the parent cooperative organization?

3. What policy implications arise from cooperative use of subsidiaries?

The study draws on the following sources of information: annual reports and other information related to specific cooperatives and their subsidiaries; literature and case histories involving subsidiaries and their use; and personal interviews with officials of eight selected cooperatives using either a unique type of subsidiary arrangement or a relatively large and diverse number of subsidiaries.

The authors acknowledge the assistance of the cooperative officials who participated in the study. Their hospitality, candidness, and interest in the study were greatly appreciated.

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Highlights

Cooperative officials in the eight large cooperatives selected for study reported use of each of their subsidiaries because of a compelling reason. The eight cooperatives accounted for 195 subsidiaries—179 wholly owned and 16 majority-owned.

The advantages to carrying out a function in a subsidiary rather than in a division or department vary from cooperative to cooperative. In general, the cooperatives studied were using subsidiaries for one or more of six purposes:

1. To facilitate management;
2. To avoid, comply with, or take advantage of certain Federal or State statutes;
3. To limit the cooperative's liability in high risk ventures;
4. To facilitate financing;
5. To enhance growth; and
6. To provide market security or production supplies in areas not otherwise served by cooperatives.

Cooperatives may also use subsidiaries to reduce costs of obtaining inputs and services.

But using subsidiaries also incurs certain disadvantages. They require additional administrative work and some duplication of facilities or other resources.

Cooperative officials strongly recommended that when a subsidiary no longer fulfills its need, the functions it performs should be pulled back into the parent operation.

Cooperative officials' definitions of a subsidiary varied somewhat. Some officials believed that control of a subsidiary could be held with less than majority ownership of voting stock. For this study, a cooperative's subsidiary is defined as a corporation controlled by the cooperative through majority ownership of voting stock, through ownership of voting stock and management rights, or through a voting trust arrangement.

The composition of the boards of directors of the cooperatives' subsidiaries ranged from all farmer members to all inhouse staff officials of the parent. According to cooperative officials, this diverse interest on boards copes more effectively with problems and issues.

The distribution of net earnings of each subsidiary depends both on its purpose and on whether it is operated on a cooperative basis. Net earnings or net margins may be distributed according to patronage to members and nonmembers alike or to members only, including a particular division providing a similar function in the parent. The parent cooperative may use the patronage refunds as income to offset operating expenses, or distribute the refunds to members according to their patronage with the parent. The latter depends on policy established by the board of directors.

The use of subsidiaries by cooperatives may move control one step further from the farmer-members of the parent cooperative. The use of subsidiaries requires good communication, i.e., that the subsidiary's officials report regularly to the parent board on its operations and activities. And it requires that the parent board "instruct" their elected directors in policy related to operation of the subsidiary.

Cooperative officials who for the first time may be interested in using a subsidiary, should consider the following:

1. Be sure that the need for using a subsidiary exists.
2. Use a subsidiary only if you have a tightly knit organization.
3. Consult good lawyers and tax people to evaluate the situation.
4. Set it up so that member control is maintained at least indirectly and net margins are distributed to the parent cooperative or to member-users.
5. Standardize the articles of incorporation and the bylaws for the parent and the subsidiary.
6. Be prepared for additional administrative work.
7. Periodically evaluate the need for the subsidiary to perform a function that could be done by a department within the parent. If the need for the subsidiary no longer exists, the activity should be carried out in a division or department.

Subsidiaries Of Agricultural Cooperatives

Charles A. Kraenzle and David Volkin★

Large regional cooperatives use cooperative subsidiaries as an important organizational tool. According to 1975 and 1976 annual reports, 15 of the top 25 cooperatives (ranked according to their 1973-74 sales) reported operating with one or more subsidiaries. Two cooperatives reported operating with 10 or more.

Information was not available for all large cooperatives relative to their subsidiaries, but for 80 which information was available, 38 were found to have one or more subsidiaries. And from the limited observations of the number of subsidiaries reported by each cooperative, in general, larger cooperatives had a greater number of subsidiaries.[1]

The data also revealed that cooperatives use subsidiaries to perform many kinds of services. These include marketing farm products, financing and leasing, oil and gas exploration, handling farm supplies, international sales, purchasing, processing, refining, manufacturing, transportation, distribution, insurance, real estate, and special services.

The increased use of subsidiaries by cooperatives raises a number of questions. Why do cooperatives use subsidiaries? Does the unique character of cooperatives compared with non-cooperative firms as well as the various legal and organizational constraints under which they operate facilitate cooperatives'

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[1]Many cooperatives consolidate their financial statements for their annual reports, but they give little or no information on name and purpose of each subsidiary.

greater use of subsidiaries? Does the use of subsidiaries lead to less control by farmer-owners? Under what circumstances should cooperatives make greater use of subsidiaries?

Members may not completely understand why their cooperative organizes a particular subsidiary. For example, they may understand little or nothing about the organizational structure of subsidiaries, how member control is maintained, and how or where a subsidiary obtains its own line of credit. Farmers and cooperative leaders could learn much from cooperative officials' experience with subsidiaries, such as problems encountered and how they were overcome.

The purpose of this study is to gather together these experiences—the benefits and the problems—to help farmers, cooperative directors, and managers avoid potential problems with subsidiary use.

Annual reports and related information were used to estimate which cooperatives use subsidiaries and the name, type, and purpose of each subsidiary. Although this source of information is incomplete and not always comparable, it does provide a useful list of various types of cooperatives operating with subsidiaries. Eight cooperatives were selected from this list for detailed study.

The second source of information—literature and case histories—was used as a backdrop for the information obtained in personal interviews. Literature was reviewed to determine how subsidiaries are defined and to clarify certain issues related to their use.

Most information in the study came from interviews with officials of eight regional cooperatives, selected to include many of the activities farmers provide for themselves by using cooperatives. If classified by type of commodity handled or functions performed the sample includes fruit, livestock, and dairy marketing, farm supply, and diversified farm supply-marketing cooperatives.

Currently, the eight cooperatives are among the leaders in the number of subsidiaries used by farmer cooperatives for a wide variety of activities.

In 1973-74, the eight cooperatives accounted for $5.37 billion of total business sales, or 15 percent of the total business volume of all agricultural cooperatives.[2]

Executives of each organization explained when and why each subsidiary was organized, how each was controlled, lines of

[2]Based on preliminary data from History and Statistics, ESCS.

credit, the relationship between subsidiary and parent, and advantages or problems with subsidiaries.

What Is A Subsidiary?

Cooperative officials differed somewhat in their definitions of a subsidiary. Most officials believed that a subsidiary is a corporate entity controlled by another organization, and that control exists through a parent[3] company's ownership of more than 50 percent of the voting stock in that corporate entity. In other words, control is taken by the corporate entity which is able to elect a majority of the subsidiary's directors. These elected directors then control the policies and management of the subsidiary corporation.

Simons and Karrenbrock report: "Ownership of a majority of the voting stock of a company assures control over that unit. In practice, however, ownership of a lesser amount generally offers control for all practical purposes, particularly when remaining stockholders are widely scattered, unorganized, and willing to delegate their voting power to the dominant group."[4]

A few cooperative officials believed that control could take place with less than 51 percent ownership. According to one official, "Theoretically, the definition of a subsidiary may be anything (any separate corporate entity) that you hold ownership (voting stock) of 20 percent or more." Although most cooperative officials refer to these arrangements as federations, affiliated companies, or joint ventures, this official's definition reflects Simons' and Karrenbrock's views.

However, a question exists whether this would be true for organizations controlled by cooperatives. A subsidiary organized under cooperative statutes or operating on a cooperative basis would have no public stockholders and voting rights by members would be limited.

For example, one cooperative (call it "A") in the study claimed a particular organization as a subsidiary and yet had only 50 percent ownership of the voting stock. Cooperative A had bought a company (call it "B") to process and market its

[3]"A corporation that controls the policies of other corporations through the ownership of their 'voting' capital stock is known as the parent company." Ralph D. Kennedy and Stewart Y. McMullen, *Financial Statements: Form, Analysis, and Interpretation*, 5th ed., Richard D. Irwin, Inc., Homewood, Ill., 1968, p. 175.

[4]Harry Simons and Wilbert E. Karrenbrock, *Advanced Accounting Comprehensive Volume*, 4th ed., South-Western Publishing Co., Cincinnati, Ohio, 1968, p. 302.

products. However, B had much more capacity than A could supply. So A sold 50 percent of the voting stock in B to another cooperative (call it "C") handling the same type products so that the necessary volume needed by B could be obtained.

Cooperative A and C elect three directors each to B's board of directors. However, A holds a management contract and retains the management rights to B. Also, if a decision before B's board of directors ends in a tie vote, the manager of A who is also the manager of B casts the deciding vote. In effect, A controls B and carries it as a subsidiary. The auditors for A, however, do not consolidate A and B's financial statements.

No examples of subsidiaries (or subsidiaries who control other corporations) were reported by cooperative officials where ownership of voting stock was less than 50 percent. Whether this is true for cooperatives in general is not known since the information was obtained from a small non-random sample.

For the purpose of this study, a subsidiary includes any cooperative or non-cooperative corporation controlled by another cooperative or non-cooperative corporation. Control can come either through ownership of the corporation's voting stock so as to allow election of a majority of the board of directors or through some combination of voting stock ownership and management rights, or voting trust arrangement.

Majority Versus Wholly Owned Subsidiaries

Cooperative officials in the study classified their subsidiaries into two types—majority and wholly owned. A company whose entire voting stock is owned by a parent company was called a wholly owned subsidiary. A company whose voting stock is less than 100 percent but greater than 50 percent owned by the parent company was called a majority-owned subsidiary.

The eight cooperatives in the study accounted for 195 subsidiaries.[5] One cooperative alone had as subsidiaries 138 wholly owned retail store corporations. In the other 57 subsidiaries, 41 were wholly owned and 16 were majority-owned. Three of the eight cooperatives also had one or more subsidiaries which in turn

[5]Not included in this count are six subsidiaries of six subsidiaries.

had a wholly owned subsidiary.[6] Table 1 shows the various activities in which subsidiaries were engaged as of November 1977.

Table 1—General classification of activities performed by subsidiaries of the eight selected cooperatives, November 1977

Activity	Number of subsidiaries	
	Wholly-owned	Majority-owned
Retailing supplies and equipment	141	—
Manufacturing and/or distribution of supplies and equipment	2	2
Procurement and/or distribution of supplies	2	1
Refining and/or distribution of petroleum products	2	1
Oil and gas exploration	8	1
Processing and/or marketing farm products	8	6
Financing and/or leasing	7	1
Insurance	7	1
Special services	5	2
Real estate	3	—
Transportation	—	1
Total	185	16

Cooperative officials reported some advantages and disadvantages for majority and wholly owned subsidiaries. According to several cooperative officials, a wholly owned subsidiary can be more easily controlled by the parent cooperative

[6]Cooperatives' use of subsidiaries when compared to non-cooperatives' use of subsidiaries appears to be very limited. In 1971, Eisenberg reported that, "Due to a number of recent legal and economic developments, a significant portion of the country's business assets is now held, not only by corporations, but by massive subsidiary corporations—mega-subsidiaries.... This dominance of many business sectors by wholly owned mega-subsidiaries is a recent development" — Melvin Aron Eisenberg, "Megasubsidiaries: The Effect of Corporate Structure on Corporate Control," *Harvard Law Review*, Vol. 84, No. 7, May 1971, pp. 1577 and 1579. In fiscal 1975, the four largest non-cooperative corporations handling fertilizer, according to their annual reports, accounted for 158 domestic and 256 foreign subsidiaries—414 in total.

because its management is part of the parent. Its entire board of directors is elected by the parent cooperative—generally by action of the parent board.

A majority-owned subsidiary's board generally is dominated by farmer members or employees chosen by the parent cooperative. The board may also include members representing majority interests. The subsidiary's management may not report directly to the parent. This gives the subsidiary more independent management. It also helps to keep the parent from "smothering" the subsidiary.

A majority-owned subsidiary opens up more opportunities for developing business with other cooperatives. Many cooperatives would rather be members of another cooperative's subsidiary for strictly marketing or other purposes rather than become involved with the problems of the parent cooperative as a member of it.[7] In other words, a majority-owned subsidiary provides an opportunity for other cooperatives to participate in a very narrowly defined activity and not be concerned with the cooperative's other corporate activities or problems.

Whether a subsidiary is wholly or majority-owned depends on the need and circumstances. As a cooperative official said, "Normally, we like to go 100 percent ownership if it is justified. We like to have control of our business if it financially makes sense. For example, we wouldn't want to own 100 percent of an offshore oil well that may topple over in the water. If a particular function is highly risky, then we wouldn't want 100 percent ownership."

Reasons or Advantages for Using Subsidiaries

An official, expressing an unanimous view, observed: "There must be a compelling reason to form a subsidiary to carry out a corporate activity rather than to perform that function within the existing corporate structure."

The officials made it clear that cooperatives do not form subsidiaries for arbitrary reasons but, as one official put it: "... if our overall corporate objectives can best be met by carrying out some functions through a subsidiary, then we'll form one tomorrow." More succinctly, another official said, "In marketing, you try to maximize returns to farmers. If your cooperative provides

[7]Many cooperatives make investments and hold membership in other cooperatives with whom they do business.

supplies, you try to minimize the cost to the farmer. If the use of a subsidiary allows you to do either more effectively, then you use it as a tool."

Cooperative officials gave the following reasons for their cooperatives using subsidiaries: (1) to facilitate management of an activity distinctly different than the basic operation of the parent; (2) to avoid, comply with, or take advantage of certain Federal or State statutes; (3) to limit the parent cooperative's liability in high risk or speculative ventures; (4) to facilitate financing from both internal and external sources; (5) to insulate certain functions from the main stream of the parent cooperative's functions as a means of enhancing growth; and (6) to provide market security or production supplies in areas not otherwise served by cooperatives.

In none of the cooperatives studied was there any indication that subsidiaries were formed specifically to enhance the salaries, power, influence, or position of the parent cooperative's hired or elected management.

A discussion of each of the reasons cooperatives use subsidiaries follows.

Facilitates management of an activity distinctly different from the basic operation of the parent

Several officials cited the fact that separating an activity—a fabricating, manufacturing, or recordkeeping activity, for example—encouraged greater precision in evaluating management performance because the accounting and other recordkeeping functions were independent of those kept for the parent.

Under a divisional arrangement top management's rather arbitrary decisions in allocating administrative and overhead costs can distort a division's operating results. Managers of a subsidiary, generally more visible and responsible for operating results, are much more concerned and vocal in accepting or rejecting overhead cost allocations.

In other words, although both a division and a subsidiary can be developed into independent profit and costs centers, a manager of a typical subsidiary has much greater control than a division manager in the determination of direct and indirect costs.

A "distinctly different" activity—insurance selling, oil exploration, or can manufacturing—is more logically carried out

under a separate corporate structure simply because of the unique character of those activities. Other factors such as legal or regulatory agency requirements in the case of insurance may override the inherent difference of an activity in considering the pros and cons of forming a subsidiary.

But several cooperative officials look at the various functions their cooperatives are performing and, because of the greater management responsibility and "bottom line" performance evaluation possible in a subsidiary, foresee a decentralization potential that could ultimately result in the regional becoming a sort of "holding" company. Thus marketing cooperatives could spin off the marketing activity from the procurement activity; split the sales function from the processing activity; and, as a matter of fact, separate the administrative function from both the procurement and marketing activities.

One manager pointed out that under the previous divisional setup, the salespeople's prime interest was in achieving volume targets; under the present subsidiary arrangement their concern for volume, though as strong as ever, is tempered by the added ingredient of increasing volume more effectively because there is a "bottom line" by which they will be measured. Thus, there is interest in product and packaging innovation, marketing research, advertising, automation, and other cost-cutting efforts. The sharpened consciousness of the "bottom line" associated with a subsidiary compared with an operating division has improved the cooperative's competitive posture.

Where a subsidiary is formed to carry out a highly specialized function, for example, if a processing cooperative forms a subsidiary to manufacture packaging materials, or repair certain highly specialized equipment, the subsidiary must be able to employ competent, specialized management for that operation.

Under a divisional setup with a long set pay scale and a hierarchical personnel situation, it may be difficult if not impossible to move people around to manage the specialized activity. And it may be difficult to employ and keep new people under the already established arrangement.

Carrying out the distinctly different activity as a subsidiary makes it far easier to employ fresh new talent at a different pay scale, with new job titles, and with the technical competence to manage that activity effectively.

Enables avoiding, complying with, or taking advantage of certain Federal or State statutes

An obvious example of a type of activity particularly affected by specific State statutes is the underwriting of casualty or life insurance. Such statutes are so strict about cash and reserves management that the only practical approach in conducting such an activity is under a separate corporate charter.

It is not unusual for a farm supply regional to form a credit corporation to purchase the regional's account receivables. The regional does this for financial leverage purposes. This is because the subsidiary generally has a greater borrowing capacity than the parent cooperative, primarily because of the liquidity of its assets.

The question can arise, however, as to which State is more favorable for incorporation. One cooperative official pointed out that a substantial amount of money is being saved by incorporating and locating the subsidiary credit corporation's home office in a State that has no excise taxes on accounts receivable purchases. Had this tax savings not been a factor, he was of the opinion that the subsidiary might have been merged into the parent organization.

Regional cooperatives involved in marketing livestock either as dealers or as meat packers are affected by the Packers and Stockyards Act and related regulations. Some of the regulations intended to prevent conflict-of-interest and collusion may impede or discourage some forms of vertical integration. As a result, cattle procurement for a cooperative meat packing subsidiary is carried out in part by another subsidiary of one regional.

And in another situation a cattle marketing cooperative decided that in-transit insurance service for its shipper-members should be provided by a subsidiary to avoid problems with both Packers and Stockyards regulations and insurance laws regarding its premium charges if handled within the tariff structure of the parent organization.

The Federal corporate income tax laws assure that a single tax will be paid at either the cooperative or patron level on net margins or earnings generated by a cooperative. By forming subsidiaries to provide specific services on a cooperative basis for specific users, several regionals are able to compute and pay patronage refunds only to users of the subsidiary's services without burdening them with membership responsibilities otherwise associated with the parent organization.

One regional has followed two different structural policies in organizing its subsidiaries, influenced to some extent by Federal tax laws. On the one hand it has brought together into one subsidiary around 100 petroleum distribution plants which individually incurred operating gains or losses. Under a centralized structure, the subsidiary's successful operation permits the payment of patronage refunds to members. On the other hand, the same regional continues to operate many of its retail stores as individual cooperative subsidiaries whose patrons receive patronage refunds based on net margins of the store they patronize.

The extent of nonmember business potential also influences cooperatives in their formation of a subsidiary. Several cooperative officials preferred to isolate certain commodity groups into a separate organization to minimize any adverse effect on the parent cooperative's tax status. Under some circumstances, a cooperative might consider forming a non-cooperative subsidiary to take advantage of the investment tax credit.

Another cooperative official held an opposite point of view. In his experience any gain through application of the credit was more than offset by taxes paid on the remaining taxable income. He pointed out that if the activity had been carried out within the cooperative's corporate structure the earnings would have been distributed in the form of qualified allocations with a lesser drain on the cooperative's working capital than occurred with the subsidiary.

Limits the parent cooperative's liability in high risk or speculative ventures

The most easily identified example of this reason is the formation of oil exploration and drilling subsidiaries. Some regionals have developed rather sophisticated partnership arrangements through a subsidiary to minimize risk to their members but at the same time provide incentive for speculative investments by others—generally high income tax bracket people. The objective of course is to enhance and assure a supply of crude oil for the regional cooperative.

Collateral requirements of some foreign countries also may be so rigorous that the only realistic way to embark on oil exploration is through a subsidiary. Egypt, for example, requires that a company pledge its entire assets as a prerequisite for oil exploration in that country. This is neither feasible nor desirable for regionals involved in such activities.

Inherent in risky situations is the opportunity for substantial gains—or substantial losses. Where losses occur the parent cooperative's management has found it much easier to liquidate the subsidiary than if the activity had been an integral part of the cooperative's services.

Cooperative officials also appeared to downgrade the limited liability of the parent organization in real life situations. Technically the parent organization's losses would be limited to its own financial interest. But in real life, taking into account the member and public impact of a liquidation procedure, these officials were, with one exception, in agreement that the cooperative would try to find means to minimize or eliminate loses by other investors. The exception to this moderate point of view related to the financial interests of the investors in oil drilling partnerships. Here losers would indeed be losers if a drilling venture was unsuccessful.

Facilitates financing from both internal and external sources

One cooperative official observed that although the cooperative provided farm production inputs to farmers and, to some degree, provided marketing services for both processed and natural-state agricultural products, members ultimately came to realize that they should find out a little more about "money" as a commodity. Therefore, that regional as well as other regionals formed finance company subsidiaries to handle conditional sales contracts, buy accounts receivables, own and lease buildings, equipment, rolling stock, and computer terminals, and engage in leveraged lease financing. Basically, such subsidiaries can leverage their equity base much higher as a finance company than the parent cooperative primarily because of the liquidity of their assets.

An important element in the financial structure of a subsidiary is whether it operates on a cooperative basis or as a noncooperative firm. If the subsidiary operates on a full cooperative basis, that is, the economic benefits of its operations go back on a patronage basis to all patrons, members and nonmembers alike, then there is little or no incentive for nonmembers to provide risk capital. On the other hand, most of the subsidiaries that do operate on a cooperative basis can borrow from a district Bank for Cooperatives, a source of capital not available to non-cooperative subsidiaries.

In this connection parent cooperatives' management sharply differed over centrally controlling funds borrowed by their subsidiaries versus permitting them to develop their own lines of credit. One regional official took the position that if the parent company management established reasonable earnings targets (in terms of return on sales or investment) and assured the subsidiary's management of input volume and competitive input costs, from there on the subsidiary's manager should be on his own in obtaining borrowed capital as well as making other decisions.

Most other cooperative officials held to a much tighter management philosophy. They preferred to manage the cash flow, negotiating loans and establishing priorities on which the subsidiary would get specific funds for specific purposes.

Another financial aspect of operating a subsidiary on a cooperative basis was the practice of staggering the subsidiaries' fiscal year-end dates which, in combination with the requirement to actually pay patronage refunds within 8½ months after the end of the taxable year, provided the opportunity to pay such refunds to the parent at varying dates during the parent's fiscal year.

Thus the parent was able to minimize or eliminate losses ordinarily occurring during certain low production months—an arrangement that could not be accomplished if these subsidiary activities were carried within the parent cooperative as operating divisions.

If the subsidiary operates as a non-cooperative corporation, it will have considerable incentive to diversify into areas that the parent cooperative may find difficult. Earnings from such "unrelated" activities would enhance the subsidiary's ability to increase its tax paid reserves. And some cooperative officials are considering not only the possibility of selling the subsidiary's stock publicly, but also using its unissued stock as a means of acquiring other businesses.

"Going public" carries with it the possibility of registering the subsidiary's securities with the Securities and Exchange Commission. The registration procedure is relatively expensive but, according to a cooperative official, it is much less expensive for a subsidiary with a narrowly defined activity than if the registration process included the parent cooperative.

As some regionals have grown both in volume and assets, their seasonal and term debt requirements may exceed the lending

limits of the Banks for Cooperatives system. Several cooperative officials believed that maintaining a regional's marketing function as a subsidiary could alleviate that problem by creating two or more smaller and separate borrowers rather than one single borrower.

Insulates certain functions from the mainstream of parent's functions as a means of enhancing growth

Cooperative officials—especially those associated with farm supply regionals—commented about the pressure members exert on their cooperatives to "get into marketing." But because the marketing function takes a specialized expertise and market orientation, several cooperatives have found that the best way to carry out a specialized marketing activity is through a subsidiary.

One significant reason given for insulating the marketing activity from main stream supply sales or from commodity procurement, is based on the rationale that a separate corporate subsidiary is the best way to maintain a separation between a production-oriented philosophy and one that is market-oriented. The ultimate objective is to put the marketing subsidiary in a position to set quantity and quality standards members must meet.

This contrasts strongly with the usual situation in which members believe that the cooperative should handle everything they produce and that quality standards should, at times, be lowered. One regional's officials believed that the separate corporate status strengthened its ability to maintain such standards to a greater degree than if the marketing function was conducted within a division of the parent cooperative.

Another cooperative referred to the tendency of producers to "smother" a cooperative's growth efforts by their natural insistence on demanding more for products they deliver to the cooperative for marketing. That official believed that a subsidiary was in a far better position to allocate scarce funds to finance growth of the marketing function rather than use them to pay for products.

Another regional official said that even when a marketing subsidiary's board was all farmers, once they were educated to the goals of the subsidiary they became much more enthusiastic about achieving those objectives.

Provides market security or production supplies in areas not otherwise served by cooperatives

Two examples sharply illustrate how the use of subsidiaries solved the problem of serving producers that could not be served under the parent cooperative structure.

The first example is peculiar to dairy cooperatives who sell raw milk to proprietary handlers and who, for one reason or another, become involved in bottling. By so doing, cooperatives compete with their primary customers.

Experience has shown, however, that when the dairy cooperative forms a subsidiary to operate the bottling function and treats it the same as it would a proprietary handler, far less complaint or suspicion of unfair competition exists than if the operation was a division of the parent cooperative.

Operation as a subsidiary also provides officials of the parent with a realistic yardstick to gauge whether handlers are operating profitably. The cooperative can thus more fairly evaluate the validity of handlers' complaints about prices and other terms of trade.

The other example involves a federated farm supply regional located in a section of the country where many farming operations are relatively new and not well established. Here farmers have little financial ability to provide equity capital for their own locally controlled cooperative. The regional—especially a wholesale operation—discovered that it could more effectively serve many farmers in its territory by forming a subsidiary that would establish and operate retail branches in strategically located areas. As a result, about 25 percent of the regional wholesale cooperative's business volume is attributed to its retail subsidiary operation.

Reduces costs of obtaining inputs and services

Two fruit and vegetable processing cooperatives (not included in the study) combined resources to produce their own cans. Each cooperative needed a certain number of various size cans each year.

Neither cooperative had the capital or the volume to build an efficient can manufacturing plant. A manufacturing plant with only one can line would be very inefficient if a number of different size cans were needed. To change a line from one size to another requires 4 to 6 weeks.

But by combining (in a majority-owned subsidiary of the larger cooperative), enough volume and capital became available to build a plant that would serve both.

The can manufacturing plant includes several lines. Thus, different size cans can be made continuously or if necessary, one line can be halted for switching to another can size without stopping production of the other lines. The cans are supplied at a much lower cost than if manufactured individually or purchased from commercial sources.

Setting up this activity in a subsidiary rather than in a division or department separates it from activities of the parent, forces the activity to stand on its own feet, and secures greater commitment from the other owner.

Disadvantages of Using Subsidiaries

Cooperative officials reported several disadvantages in the use of a subsidiary over a division performing the same function. Most of these problems were not related to the function itself but to the organizational structure and administrative functions.

Requires additional recordkeeping and management

Keeping separate bank accounts, a separate set of minutes, and filing separate tax returns are necessary. More meetings are created for management and directors. Additional effort must be made to see that the operation of the subsidiary complies with corporate laws and regulations. The use of a subsidiary does bear extra costs. As one cooperative official said, "From an organizational standpoint, the use of subsidiaries makes everything much more complicated."

In some subsidiaries, facilities or other resources must be duplicated. Most cooperative officials in the study reported that they tried to minimize this as much as possible. In some cases, the headquarters of one or more subsidiaries were in the same building, sharing many of the same services on a cost or contract basis.

May complicate cash flow management and communications

One parent cooperative manager believed he minimized some cash flow and communication disadvantages by also managing the operations of the subsidiary. In this way, he could communicate to the production people in the marketing organization (parent) what needed to be produced.

Because of its individual identity and separate board of directors, a subsidiary may cause some conflict between the production and marketing groups.

May insulate a section of a cooperative's activities from member control

Most cooperative officials, however, appeared to minimize this as a problem. One official said members are concerned about the availability of services—they look to the whole organization to provide them. They don't care if the cooperative's basic logo appears in different forms on the fuel oil truck and the feed delivery truck.

Other possible problems

Another official could foresee problems if a subsidiary's board included too many nonmembers or "outsiders." Many of the subsidiaries included key management staff people on their boards as well as farmer members of the parent board.

The possibility also exists that a subsidiary's management will assert its autonomy by incurring expenditures and staff not in conformity with the style of the parent. Such a situation requires the parent to exert its control over the subsidiary.

One cooperative official also mentioned that it was more difficult to liquidate a subsidiary operating at a loss than to eliminate the same operation within a division. For example, his cooperative had to liquidate such a subsidiary and the parent cooperative had to absorb the accumulated loss at one time. If the operation had been in a division, the parent cooperative could have absorbed the loss as it went along. Losses from liquidation impaired the value of the parent's investment in its subsidiary's stock.

On the other hand, one could agree that the visibility of a subsidiary's losses would make it much easier for members to realize that the cooperative was involved in a losing proposition.

Subsidiaries' Boards of Directors

A previous section of this report makes the point that "... control (of a subsidiary) is taken by the (cooperative) corporate entity which is able to elect a majority of the subsidiary's directors." The composition of subsidiary boards varies widely from those dominated by farmer board members of the parent

cooperative to those that include a preponderance-or all—of the parent's in-house staff officials as well as other nonfarmer "outsiders."

The dairy regionals studied rely heavily on either their own producer board members or producers elected from a subsidiary's procurement territory to serve on their subsidiaries' boards. This is true whether the subsidiary is involved in manufacturing, bottling, handling farm supplies, or providing a transportation, insurance, or other service function. Generally either the subsidiary's hired management or the parent's chief executive officer report to the parent board about the subsidiary's affairs.

Essentially the same situation exists in the livestock marketing cooperative included in this study. The parent's board of directors (all but one being livestock producers) also serves as the board of directors of all subsidiaries. In addition, the president and general manager of the parent cooperative also serves as president and general manager of all the subsidiaries.

As a matter of fact, one board meeting provides the basic forum for discussing and reporting the subsidiaries' affairs to the parent board. These reports are handled by staff people called "vice-presidents in charge of marketing" of each subsidiary. Under these rather tightly knit circumstances, the ordinary member doesn't even care if he is dealing with a subsidiary when he is negotiating with an order buyer, handling cattle under a contractual basis, or purchasing insurance for his local shipping association.

In another example, however, the split between the marketing subsidiary and the parent procurement cooperative is accentuated by the fact that of the subsidiary's nine directors only three are directors of the parent cooperative. The other six directors include three of the subsidiary's executive management people and three outside businessmen.

The basic philosophy of this arrangement is that the grower members of the parent cooperative confine their activities to what they know best—producing and delivering the crop. They leave the processing, marketing, and distributing to specialists in those fields.

Thus, the preponderance of management and outside businessmen on the subsidiary board enables the subsidiary to better cope with the basic issues of how best to market the crop to insure adequate payments to producers while at the same time providing adequate capital to guarantee the future of the business.

Although this group has no formalized procedure for the subsidiary's three grower board members to report back to the parent board, a direct line of communication exists between the two organizations because the grower president of the parent cooperative also is the chairman of the subsidiary board. In addition, the subsidiary's senior vice presidents routinely report to the parent board.

Farm supply regionals tend to use the parent cooperative's inhouse staff people as board members of subsidiaries that carry out highly specialized functions. For example, wholesale supply regionals that formed credit, insurance, importing, management, and oil exploration subsidiaries used the parent's inhouse people to serve on the subsidiaries' boards. Where the wholesale regional forms a subsidiary to operate retail branches, however, farmer patrons will probably be chosen to serve on the retail subsidiary board.

Several different philosophies surfaced on electing outside business men to serve on a subsidiary's board of directors: One point of view holds that it is difficult to project how long it will take for the outsider to understand the problems facing the cooperative to the point where he can be useful. Quite often, the problems of non-cooperative corporations are not always the same as those faced by cooperatives. An outsider will also be making decisions without the full burden of responsibility. Some officials believe that a subsidiary can obtain expertise without bringing people on the board, but by using consultants or hiring managers with special skills.

Another point of view was expressed by an official of one organization whose bylaws required that directors be member-producers. Although he believed there may be some advantage in using people from the outside, he would rather set up advisory committees—a more informal structure that would perhaps be free of the legal connotations surrounding a board's actions.

People from the outside who are elected to the board bring in an unbiased point of view, according to a third point of view. Outsiders can also bring to the board the experience to make multi-million dollar marketing decisions, a qualification farmers may not have.

Finally, outsiders who are elected to the board develop a greater source of pride and dedication for success of the business

than if hired as consultants. Outsiders, a few cooperative officials believed, do not feel any less responsibility than do member-directors.

Distribution of Net Margins or Net Earnings

Subsidiaries of the cooperatives visited handled earnings in various ways. As an official of a large supply cooperative reported, "You can't generalize for this organization and say that the earnings of each subsidiary are allocated back to each division and through to its (the parent's) members. It depends on the purpose of each subsidiary to its (the parent's) members. It depends on the purpose of each subsidiary and why it was formed before you decide how the earnings are allocated."

For example, earnings from business done by the parent with a majority-owned subsidiary that formulates and distributes agricultural chemical products are distributed back to the farm chemical division of the parent. The division then allocates these earnings to its patrons. In another majority-owned subsidiary, earnings go directly back to members.

Officials of a dairy cooperative explained that in their subsidiaries, both members and nonmembers receive the earnings. One subsidiary sells various supplies, equipment, and services to members and nonmembers, and earnings are allocated alike to both types of patrons. One reason that these supply activities are being performed in a subsidiary is to allow the parent to limit its activities to members. The parent's earnings are distributed strictly to member patrons.

This same cooperative also has a majority-owned subsidiary to market manufacturing grade milk of (ungraded) milk producers. Earnings of this subsidiary are allocated to members as "net retained margins" according to patronage.

Most farmers who market milk through the subsidiary are members. About 40 percent of the milk volume handled by the subsidiary comes from the parent organization. Since the manufacturing grade milk is handled by the subsidiary, the parent's patronage dividends need not be allocated to ungraded milk producers.

This subsidiary is controlled through the election of five out of nine board members. The other four board members are elected by manufacturing milk producers in four districts.

A wholly owned bottling subsidiary allocates its earnings back to the parent. The earnings become an income item on the parent's books in the year received. The parent cooperative can use this income to offset its operating expenses, or it can refund it to patrons. It is up to the parent's board of directors to decide what they do with the patronage refund. In this particular case, it is set aside and paid in cash to all producers.

One cooperative, whose subsidiaries pay specified dividends on member equities, allocates earnings from a single pool. Reserves and dividends are deducted from the pool and the remainder is available for patronage refunds. The amount refunded to each member is based on his dollar volume of business with the cooperative.

A supply cooperative that has two wholly owned credit subsidiaries—one to discount trade acceptances and the other to discount member cooperatives' paper with farmers—receives all net earnings of these subsidiaries. The net earnings are then used to offset the parent organization's interest expenses.

Another supply cooperative organized a credit subsidiary to help locals in financial trouble because of delinquent receivables. At first, the parent was the only owner and member. After some buildup in the subsidiary's capital base, local cooperatives became members and began sharing in patronage allocations.

Earnings of the subsidiary are distributed as follows: (1) Twenty percent is set aside as a tax-paid allocated reserve; and (2) the remaining 80 percent is distributed as patronage refunds with 20 percent paid in cash.

In another wholly owned retail subsidiary that was organized for the purpose of improving poorly managed and poorly financed locals that were close to insolvency, the parent's bylaws do not permit farmers to become voting members. However, farmers are nonvoting members for the purpose of receiving patronage refunds.

The earnings from this subsidiary are distributed as follows:

1. Earnings from nonmember business are retained as tax-paid reserves.

2. In any event, 6 percent of earnings from member business is set aside for addition to prior years' retained earnings.

3. An amount is then deducted for taxes. If the earnings remaining are not sufficient to pay taxes on retained earnings and paper received by the subsidiary, then retained earnings are used

to pay taxes. If any earnings are left over, the board has authority to put 50 percent into retained earnings.

4. Cash patronage refunds are then paid to farmers based on their dollar volume with the subsidiary. No patronage refunds are paid in noncash form.

Back in the early seventies, this same cooperative greatly needed a management information system dealing with some of its member cooperatives—particularly those with management contracts. In the whole process of establishing this, the cooperative developed a computerized uniform accounting system for the local member subscribers. Included in the system were sales analysis, general ledger accounting, departmentalized balance sheets and operating statements, accounts receivable records, corporate financial and operation statements, patronage and equity records, a program for distributing patronage refunds, and patronage purchase records.

Because of interest shown by nonborrowers of their credit subsidiary, the cooperative decided to form a subsidiary "...to go its own way" so that the staff involved in the information system was separated from the parent's own accounting staff. The subsidiary then began to supply services to the parent company, branches of the retail subsidiary, and to member companies. Eventually, the subsidiary started to "sell" its services. Currently, it serves 33 members companies and 15 of the retail subsidiary's branches. Special accounting programs have even been developed for nonmembers interested in using the subsidiary's services.

Officials in the subsidiary maintain strict confidentiality of reports produced for locals that do not borrow from the parent's credit subsidiary. Even the parent is not provided access to that information. Locals that do borrow from the credit subsidiary are required to subscribe to the information system and to agree that the parent's officials have access to such information.

As for distribution of earnings, the subsidiary pays only cash patronage refunds. Part of the total allocation goes toward a non-voting and a nonrefundable $500 membership.

Another cooperative with a wholly owned marketing subsidiary receives all earnings from its subsidiary and distributes them to its members. The parent, however, has marketing agreements with members and a crop purchase agreement with the sub-

sidiary. Patronage refund paper held by members can be traded without board approval, and sold to anyone. The patronage refund paper does not carry membership voting rights; only the membership marketing agreement and a specified number of acres of the product marketed carry voting rights.

Some Policy Implications

Policy implications that could arise out of cooperatives' use of subsidiaries involve such areas as member control and taxation.

Member control

At least one manager expressed concern about the long-term policy implications if subsidiaries organized as cooperatives have boards overloaded with nonfarmers. He speculated that lack of member control could become an issue. In other words, "Who is minding the cooperative" might be a crucial question.

The Capper-Volstead Act allows persons producing agricultural products to "act together in associations" to market their products without being in violation of the anti-trust laws. The Act, however, requires that such associations be operated for the members' mutual benefit and conform to one or both of the following requirements:

"First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein, or,

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum. And in any case to the following,

Third. That the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members."[8]

A cooperative association must have only producers or associations of producers as voting stockholders if it is to fall within the Act. In other words, total control must be in the hands of member-producers through their eligibility to vote for directors. And this control must be of such a nature "...that such associations are operated for the mutual benefit of the members thereof,

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[8]42 Stat. 388; 7 U.S.C. 291 and 292.

as such producers." This mutuality concept has never been fully explored.[9] It does, however, suggest that an association be operated for the good of each member and that each member have the same relation with the association as any other member.

The Act does not require that cooperative directors be members. In cooperative associations, producer-members elect certain people, usually members, to serve on the cooperative's board of directors.

"...all the corporate powers of a cooperative, other than those specifically conferred on the members, are in its directors. Thus, the directors of a cooperative collectively and primarily possess all the powers that the cooperative has under the law. Although these powers are executed by the officers, agents, and employees of the cooperative, the authority for their acts is found in the board of directors. The board determines either expressly or by implication, directly or indirectly, the acts to be performed and the plans and methods to be followed by the officers, agents, and employees of the cooperative."[10]

Unless required by cooperative statutes, charter, or bylaws, directors need not be members.[11] However, most cooperative statutes require that directors be members or stockholders. Some cooperative experts believe that a member-director who is an owner and user will take greater interest in seeing that the cooperative sticks to its purpose, ensuring good management.

From this report's earlier description of the composition of subsidiary boards, it is apparent that they vary widely from those that include farmer members of the parent and of the subsidiary, to those with inhouse staff officials and other nonfarmer "outsiders."

These boards make the policy decisions for the subsidiary and control the entity. It is useful, therefore, to review some rather substantial areas for decisionmaking and think through how a parent cooperative's members can be insulated by the interposition of another board between them and an activity carried out by a subsidiary.

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[9] David Volkin, *Key to Understanding Capper-Volstead*, Reprint 392 from July 1974 News for Farmer Cooperatives.

[10] *Legal Phases of Farmer Cooperatives*, Info. 100, FCS, USDA, Washington, D.C. p. 119.

[11] Ibid. p. 120.

A subsidiary's board—if it is operated on a cooperative basis—will make determinations regarding the cash and noncash patronage refunds paid by the subsidiary. It will make decisions as to the timing and priority for redeeming the subsidiary's outstanding equities. It will decide how the subsidiary will handle losses. And, whether it operates on a cooperative basis or not, the subsidiary's board will set management pay scales and determine expenditures for market research and penetration, as well as political and charitable contributions. All of these might be at a somewhat different level if the activities were carried out as a division of the parent and thus under its direct control

Cooperative subsidiaries that are wholly owned are, in effect, one-member cooperatives. That is, the parent cooperative is the sole member. The parent's board elects the subsidiary's board by casting its ballots at the subsidiary's annual meeting. The parent board may elect all or some of its own board members, or, if not restricted by cooperative statute, charter, or bylaws, it can elect staff people, outsiders, or farmer patrons of the subsidiary to the subsidiary board.

If a wholly owned cooperative subsidiary were to have direct member control similar to its parent, then the directors of the parent should also be the directors of the subsidiary. This is not to argue that member control is automatically weakened by electing other than parent board members to the subsidiary board. It does, however, move control one step further from the farmer-members of the parent cooperative.

Assume, for example, a situation where no members of the parent board are on the subsidiary's board. And that a majority of the farmer-members of the parent are dissatisfied with a particular activity of the subsidiary. Members would make their desires known to directors of the parent board. The parent board would then instruct the directors of the subsidiary to discontinue the particular activity. In this situation where the directors of a subsidiary are different from the directors of the parent, member control may be affected in two ways:

One, the subsidiary board may have a different philosophy than the parent board. Their objectives may differ from those desired by the producer-members of the parent. Thus, the subsidiary may be involved in activities that the parent board would not have approved if it had made the initial decision. Situations like this require strong parent boards if strict member control is to be maintained.

Two, the parent's directors may not know what the subsidiary is doing. A lag also exists between the time the subsidiary's board makes a decision and the time information on this decision reaches the parent board.

Poor communication between a parent and its wholly owned subsidiaries may lead to loss of member control. Good communication requires that the subsidiary's officials report regularly to the parent board on their operations and activities. The parent board must, in turn, "instruct" elected directors in policies related to operation of the subsidiary.

A general observation could be made that in most cooperatives studied no clear cut "instructions" were given by the parent board to its own members on a subsidiary board. Nor was there a formalized procedure to make the subsidiary's board accountable to the parent board. In other words, a subsidiary board could approve a subsidiary's advertising policies or financing program, for example, without close coordination with the parent board. Under such circumstances, parent board members could find it difficult to explain cooperative activities to their producer-members without pleading ignorance to a subsidiary's activities.

Cooperative majority-owned subsidiaries may have other cooperatives or individual producers as its members. If the subsidiary has a one-member, one-vote method for electing directors the parent cooperative could lose control of the board. This situation rarely occurs because the parent generally is in a position to elect the majority of the board regardless of the makeup or investments of other members.

Another significant factor in determining the extent of the parent cooperative's member participation on a subsidiary's board is whether the subsidiary is organized under the general business laws of a State or as a cooperative under a State cooperative law. If the subsidiary is organized under a cooperative law, then only producers can be members, and most, if not all its directors may be producers.

If a subsidiary is organized under the general business laws of a State, the parent board may have considerably more leeway in electing a subsidiary's board because a board member will not have to be an agricultural producer. A number of subsidiaries are organized under the general business laws of a State but operate on a cooperative basis insofar as distributing their earnings on a patronage basis.

Taxation

Differential tax treatment and limited exemption from the antitrust laws are afforded associations of producers. The Federal tax statutes describe such organizations as "any corporation operating on a cooperative basis."[12] The tax statutes and related regulations, however, do not expressly define the substantive principles that constitute "operating on a cooperative basis." Therefore, the Internal Revenue Service does generally determine those principles and interpret their meaning.

A recent Technical Advice Memorandum held that an association is operating on a cooperative basis if it adheres to the one-man, one-vote principle or has weighted voting based on "current" patronage. In other words, IRS says that an important basis for differential treatment of cooperatives is their difference in control—i.e. their conformance with democratic control principles. Cooperative members democratically choose their own methods for electing directors who in turn determine association policy.

Therefore, when tax, antitrust, and other regulatory agencies are concerned with whether cooperatives operate under democratic control principles it would seem reasonable to assume that their interest would extend to cooperatives' subsidiaries.

As to the income tax treatment of cooperatives, several IRS revenue rulings have made the point that a parent cooperative's Section 521 status can be affected by the subsidiary's operations. A subsidiary cannot engage in activities not permitted by IRS to the parent.

As IRS continues to explore and refine its definition of "operating on a cooperative basis" its findings may assure a strong role of members in controlling cooperatives and their subsidiaries. Such IRS interpretations would not go unnoticed by other policymakers.

Other questions

Cooperative use of subsidiaries raises other important issues that need to be studied.

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[12]Section 1381 (a) (1) of Subchapter T of the Internal Revenue Code.

Can a cooperative subject to State cooperative statutes organize a subsidiary under State general corporation statutes to carry out a function that may be beyond the regulations affecting the parent cooperative? Do any legal and policy implications evolve?

Would any policy issues arise from cooperatives adopting the holding company form of organizational structure?

Can a marketing cooperative use a subsidiary to market products unrelated to member products? What are the legal and policy issues related to cooperative use of subsidiaries for diversification?

How are outside audits for each subsidiary used and reported? And what is the most appropriate method of building and approving budgets for a subsidiary—especially a majority-owned subsidiary?

Are lending institutions such as the Banks for Cooperatives encouraging or discouraging the use of subsidiaries by cooperatives? Should a subsidiary not eligible to borrow from the Banks for Cooperatives be allowed to use funds obtained by the parent from the Banks? Generally, what effect if any can a subsidiary have on the eligibility of its parent cooperative to borrow from the Banks for Cooperatives?

Cooperative leaders need to give serious thought to these questions. They may avoid many problems by evaluating possible implications from the use of subsidiaries prior to establishing them.

Organizing a Subsidiary

The creation of a subsidiary corporate entity involves an incorporation process and subsequent activities associated with that process. These include the selection of a board of directors, the hiring of staff people, the setting up of a recordkeeping system, the holding of directors and stockholders meetings, the filing of regular corporate reports, and all the other activities generally associated with the functioning of a corporate entity. These carry a price tag that either are not incurred or are minimized if the activity is conducted within the exising cooperative corporate structure under a divisional or departmental arrangement.

Cooperative officials were asked what advice they would give to officials of another cooperative desiring to use, for the first

time, a subsidiary as an organizational tool. Officials were very explicit in saying that:

1. ... "You have to have the need...You need to have thought through the reasons why you want to do it this way... There is nothing wonderful or inherently good about subsidiaries ...You should think through the problem and see if there is a need for a subsidiary."

2. "You should make sure the reason you form a subsidiary is worth more than the mechanics you have to go through to keep it as a subsidiary corporation." Keeping a separate set of books, separate tax returns, and carrying out additional administrative duties add to the workload and costs. Good lawyers and tax people should be consulted when setting up a subsidiary. They should be able to predict the burdens it will impose. Every situation is going to be different—expecially from a tax viewpoint.

3. The current organizational structure of the parent cooperative should also be taken into consideration. Cooperative officials in one organization believed that in a loosely controlled organizational environment, a subsidiary could become a real headache. If a cooperative is to use subsidiaries, then it should have a tightly knit organization.

4. The subsidiary must be set up so that the parent can maintain control. The parent's directors will need to "instruct" their elected directors on policy desired and they must continuously keep themselves informed of its operations. The decision must be made on how to distribute the subsidiary's earnings, if this is not one of the primary reasons for separating the activity in the first place.

5. Each subsidiary should be set up according to a uniform organizational structure. Uniformity, the officials explained, is to standardize, if possible, the articles of incorporation and the bylaws for the parent and each subsidiary. Standardization of the articles could be accomplished by incorporating the subsidiary within the same State in which the parent is incorporated. By using the same State, keeping up with all kinds of changes in other State laws can be avoided. As one official observed, "It is a real job to keep up to date on laws."

The bylaws should be developed with the same language wherever possible. By using the same wording, officials will not have to reorient themselves every time they plan to do something.

Problems in electing directors and appointing officers can be minimized if the organizational papers are compatible with those of the parent.

One cooperative with four subsidiaries recently had amended all bylaws in order to standardize them, consulting a law firm for guidance. The cooperative's top official suggested that organization papers should be standardized and updated as much as possible.

6. One cooperative official reported that a cooperative must also be prepared for some administrative problems because of the need to adequately structure their controls. His particular cooperative had minimized such problems by placing all administrative functions in a separate vehicle—a wholly owned subsidiary.

7. Once a subsidiary is organized and functioning, periodically evaluate it to see if the need for it still exists. If the need for a subsidiary no longer exists, then its function should be pulled back into the parent.

Conclusions

The large agricultural regional cooperatives are using subsidiaries to perform a wide variety of services. Specific benefits that can be realized from performing certain services in a subsidiary rather than within a division or department are:

1. Separation of distinctly different activities as well as accounting and other record-keeping functions;
2. Separation of operating philosophies such as marketing from production;
3. More "bottom line" orientation;
4. Improved management;
5. Employment of new people with new job titles and different pay scales;
6. Compliance with Federal, State, or tax regulations;
7. Reduction of risk to parent cooperative;
8. Improved financing;
9. Enhanced product marketing or growth;
10. Provision for market security or production supplies in areas not currently served by cooperatives;
11. Avoidance of suspicion of unfair competition;
12. Provision of a competitive yardstick; and

13. Cost reduction in obtaining inputs and services.

Using subsidiaries also makes it easier to enter into activities that the parent cooperative may not do or find difficult to do. Examples include the sale of public voting stock or the diversification into activities unrelated to member business.

Subsidiaries of the cooperatives studied were established because of one or more of these advantages. There was no indication of subsidiaries being established to enhance the salaries or influence of management. In most cases, where the benefit no longer existed, the activity performed by the subsidiary was brought back into the parent cooperative's operations.

Even when beneficial, subsidiaries pose certain disadvantages to the parent cooperative. They incur additional costs requiring more administration and some duplication of resources.

Some administrative responsibilities can be minimized by standardizing the articles of incorporation and bylaws for the parent cooperative and its subsidiaries. Resource duplication also can be limited by the parent sharing resources with subsidiaries on a purchase or contractual basis.

But the use of subsidiaries by cooperatives does potentially weaken member control. This would be especially true if subsidiary boards were overloaded with outsiders, did not include parent board representatives, and if communication was poor between the parent and subsidiary boards.

Member control of subsidiaries can best be maintained by having wholly owned subsidiaries with the same board for the subsidiaries as for the parent. Several advantages, however, exist for using majority-owned subsidiaries and for having other than parent board members on subsidiary boards. Acquiring directors with specific expertise is a good example.

No matter who is elected to the boards of subsidiaries, member control (especially of a wholly owned subsidiary) is the responsibility of the parent board members. If they want to control the subsidiary, they can. And as member representatives, the parent board members have a binding *duty* to do so. Parent boards should "instruct" their elected representatives serving on subsidiary boards in the monitoring of budgets and audits and the policy desired. Cooperative officials should not plead ignorance to what goes on in subsidiaries when it concerns major policy issues.

Member control is related to financial control. A parent cooperative that allows each subsidiary to develop its own line of credit is relinquishing some control. Also, some serious financial problems could arise. Much tighter member control can be obtained by the parent cooperative managing cash flow and, in this connection, negotiating loans and establishing financial priorities.

Farmers as owner-users should be informed and if possible better educated on the role of subsidiaries. In many cases, farmer-members may not realize the service they are receiving is being performed through a subsidiary. Even though cooperative members may receive better service through their cooperative's use of subsidiaries, members have a right and a responsibility to know what is going on and why.

Cooperatives' subsidiaries, whenever it is possible, should be operated on a cooperative basis to assure that their economic benefits go to those who use their services. The parent board should establish this policy. The subsidiary's board of directors should determine how net margins or net earnings are distributed.

Parent cooperatives may alter the fiscal year endings for subsidiaries in order to average out income received by the parent. Care, however, should be taken so that in doing so, members of the parent cooperative are not misled as to the financial condition of the cooperative.

When a subsidiary no longer provides any greater benefits or advantages than if it were a division, then the activity it performs should be brought back into the parent company's operations. This will move the activity level closer to member control and eliminate the additional administrative responsibilities and possible duplication of resources.

As cooperatives expand their use of subsidiaries, more questions and policy issues will arise. Further research into cooperatives' use of subsidiaries should help resolve these potential issues.

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Economics, Statistics, and Cooperatives Service

The Cooperative Program of ESCS provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

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